question. These organizational costs should represent costs that benefit ratepayers, in that they must necessarily be incurred for the entity to be able to provide service. For that reason, we conclude that we should presumptively allow these costs into the ratebase to the extent they are prudently invested and are useful in the provision of regulated cable service. Operators will be allowed to continue to recover their capitalized organizational costs based on GAAP through amortization over a reasonable period, subject to scrutiny by the appropriate regulatory authority as to the reasonableness of rates produced by the recovery period.[180]

87. Franchise Costs. The original costs of government franchises are often allowed into the ratebase under traditional cost-of-service principles, because they must necessarily be incurred for the entity to be able to provide service.[181] We conclude that we should allow the original costs associated with a government franchise into ratebase if they: (1) are associated with the costs of winning the franchise; and (2) in the case of purchased systems, are costs that were directly borne by the seller. We conclude that we should presumptively allow these costs to the extent they are prudently invested and are useful in the provision of regulated cable service. Operators will be allowed to continue to recover their capitalized franchise rights based on GAAP through amortization over a reasonable period, subject to scrutiny by the appropriate regulatory authority as to the reasonableness of rates produced by the recovery period.

88. Customer Lists. Customer lists, too, are presumptively allowed into ratebase, to the extent that they reflect costs capitalized during prematurity, as defined by FASB 51, and are prudently invested and are useful in the provision of regulated cable service. Operators will be allowed to continue to recover these costs through amortization over a reasonable period based on GAAP, subject to scrutiny by the appropriate regulatory authority as to the reasonableness of rates produced by the recovery period.

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180 We note that it is not necessarily the case that the time period until renewal of a franchise is the appropriate capitalization period for organizational costs, because we believe there is an expectation of franchise renewal. Proponents of some period other than the franchise period should support their proposal.

181 See 47 C.F.R. § 32.2690.

3) Intangible Costs Presumed To Be Excluded From Rates

89. Acquisition Costs. The issue of whether the acquisition costs of cable systems should be considered or accepted for computing ratebases and revenue requirements overlaps to a degree with the question of the plant valuation method that should apply. But the two matters are distinct, especially under the particular circumstances presented by the reimposition of cable service rate regulation by the Cable Act of 1992. Regardless of the valuation method that might be applied now and in the future, the issue cable operators raise is whether the cost-of-service methodology we apply should recognize the prices paid for cable systems in the past, especially during the period when systems were unregulated.

90. The issue is one of some importance and controversy, for both operators and customers, because many cable systems changed hands during the years when cable service was essentially unregulated, and in many cases the prices paid exceeded the original cost or the book value of the purchased cable system's tangible assets. These costs to the buyer, which we have termed excess acquisition costs,[182] were presumably recorded as goodwill. In arguing for recognition of acquisition costs for computing costs of service, the cable operators claim, variously, that the price paid is either a measure of the fair value of the system, or the proper valuation for assets brought into regulation, or a proper exception to the usual valuation rules to recognize the need for a transition tailored to the characteristics of the cable industry, or a constitutional requirement to prevent confiscation.

91. We continue to believe that the prices paid for cable systems, especially during the period when those systems possessed market power, are not a reliable or reasonable basis for ratemaking, and that their use is not required or supported by public utility practice, the purposes of the Cable Act of 1992, or the Constitution. It appears certain that those prices often include some expectation of supra-competitive profits that the market power of cable systems operating in a less than fully competitive environment could expect to generate. The magnitude of this expectation probably varied over time, increased by the growing list of cable channels that could be obtained only by subscribing to cable service, and discounted by the investors' assessment of the risks of competitive entry and re-regulation.

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[182] Notice at n.40; see also Ratebase Order and Illinois Bell (discussing plant acquisition adjustments in the telco context).

But buyers and sellers negotiating acquisition prices clearly took into account the competitive status of cable systems and their consequent market power. Individual investors purchasing shares in cable companies no doubt also included this factor. The analysis we conducted as part of our development of governing rates set under the benchmark approach strongly supports this conclusion. The study submitted in support of the use of acquisition prices by Viacom, one of the largest cable operators, also recognizes the possibility that capitalized monopoly profits were included in those prices, though it suggests a smaller effect.[183]

92. It is also quite likely that acquisition prices included assessments of the profits that might be gained from emerging cable services that remain unregulated but could be expected to experience more rapid growth and penetration than those services that were made subject to regulation. Premium services such as HBO and Showtime, pay-per-view services, interactive services such as home shopping, and other offerings all represent newer sources of profit with greater potential for expansion. System prices can reasonably be expected to include the potential earnings for these actual and planned offerings. Moreover, it is certainly possible that even arm's-length transactions resulted in prices that were simply too high, transactions based upon overly optimistic projections of growth, the direction of the economy, and the buyer's ability to reduce operating costs or increase the value to customers.[184] Acceptance of these prices as a fair measure of the value of the facilities used to provide regulated services would require customers for those services to act as guarantors of the recovery of those prices, regardless of how inflated they might have been.

93. Traditionally, such excess acquisition costs have been partly or wholly excluded from the ratebase of regulated concerns, because these costs are seen as inappropriate costs for

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[183] The Kolbe/Vitka Study estimates, based upon stock price movements of publicly traded cable companies that capitalized monopoly profits are likely to represent less than 10 per cent of the pre-regulation value of cable companies' assets. Viacom Comments, Appendix at 2, 18-27.

[184] See, e.g., COA Comments at 42 ("There are certainly examples of cable purchasers who paid too much. Similarly, there are some operators who purchased properties and raised rates without improving service, merely to cover the cost of debt service.").

ratepayers to bear.[185] This is because these costs typically benefit the seller, not the ratepayer; they do not contribute to the plant supporting regulated service. We also note that disallowance of goodwill for monopoly cable systems is consistent with findings of the United States Tax Court.[186] We believe that disallowing acquisition costs, to the extent they include captialized supra-competitive profits, is consistent with, if not indeed compelled by, the theory and purposes of the Cable Act of 1992. The Act does not instruct us to consider acquisition costs or the prices individual shareholders paid for cable companies before the adoption of the Act. The language and legislative history of the Cable Act of 1992 demonstrate a primary concern with preventing the undue market power of cable operators subject to neither regulation nor effective competition from setting supra-competitive rates.[187] Allowance of the acquisition price of cable systems as part of the costs of service would present a substantial probability, in our view, of passing on to customers costs that reflect neither the costs of providing service nor the costs that would be incurred under competition.

94. We also find unpersuasive arguments that acquisition costs should be accepted because they represent the arm's-length purchase prices of assets. While the market price paid for assets may be presumed to be an appropriate measure of the original cost in many regulatory contexts, for example because it is likely to represent the value of the asset to ratepayers at the time the utility begins using the asset to provide service, that is not the case here. As we discussed above, the acquisition prices paid prior to the Cable Act of 1992 are likely to be inflated in various ways, notably by the expectation of supra-competitive profits. Because of this, it is not reasonable or fair to ratepayers to include those prices presumptively or automatically in the ratebase.

95. Moreover, we also do not believe that the acquisition price should be accepted as representing the value of the assets at the time the system was dedicated to the public service, or

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[185] E.g., 47 C.F.R. §§ 32.2005, 32.2007; San Diego Land & Town Co. v. National City, 174 U.S. 739, 757-758 (1899); Simpson v. Shepard (Minnesota Rate Cases), 230 U.S. 352, 454 (1913).

[186] Tele-Communications, Inc. v. Commissioner of Internal Revenue, 95 T.C. No. 36 (1990).

[187] S. Conf. Report No. 102-92, 102d Cong., 1st Sess. 8-11 (1991). We note that the record contains arguments both supporting and contradicting the view that cable rates reflect anticipation of supra-competitive earnings.

that, even if this were the case, the acquisition price should be accepted for ratemaking. Cable systems were providing service to the public prior to the reimposition of regulation under the Cable Act of 1992, and generally were subject to local franchises. The reimposition of regulation recognized the existence of their market power, and sought to restrain it. Allowing into the ratebase prices that reflect and capitalize that market power would effectively perpetuate that market power rather than, as the Cable Act of 1992 plainly intended, protect customers from it.

96. An alternative approach, which we set for comment in the Notice and which is urged by some commenters, is not to use the acquisition price as a measure of value for setting the ratebase, but to permit excess acquisition costs to be recovered through amortization over a period of years. This approach would reduce the amount that customers would be liable to pay in order to compensate operators for their acquisition costs by not permitting operators to earn a return on such costs, but would still permit operators to recover all such costs. The comments also propose other mechanisms that would effectively permit acquisition costs or the debt service costs associated with acquisition costs to be recovered from ratepayers.[188]

97. Commenters favoring some form of recovery argue that acquisition costs should be allowed in fairness to buyers who could not have expected that rate regulation would be imposed, or that denial of full acquisition costs will impede the ability of the cable industry to obtain financing to improve its facilities and programming offerings. We conclude, nonetheless, that inclusion of acquisition costs that do not provide value to subscribers would undercut the purposes of the Cable Act of 1992 and unnecessarily favors operators over subscribers, by requiring subscribers to pay rates above the levels of the costs actually and reasonably applied to provide regulated service, and above the costs that would likely be incurred under competition. We thus reject the various approaches suggested to include

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[188] See, e.g., Comcast Comments at 36 (proposing a Z factor adjustment to the price cap to permit the recovery of and an adequate return on an operator's net investment in tangible and intangible assets which would not otherwise be recovered under the price cap rules); Georgia Cable Comments, Appendix A (proposing a marginal cash flow test that would find rates not unreasonable so long as the ratio of operating cash flow from all cable services to the sum of debt service plus capital expenditures does not exceed 1.20:1).

acquisition costs in the ratebase.[189] As we discuss above, allowing operators to claim categories of intangible costs that do in fact represent reasonable costs of providing service that benefit subscribers, while not permitting supra-competitive and other unreasonable costs from being imposed on subscribers, is fair to operators and investors and to consumers.

98. Operating Efficiencies. There may be sales, as some commenters claim, that benefit subscribers by generating operating efficiencies that are unobtainable by the seller. We believe it is appropriate to consider whether these efficiency gains warrant inclusion of some part of goodwill in the rate calculation. However, in any such case, the operator must clearly rebut the presumption against including goodwill by demonstrating the nature and value of the net efficiency gains and, most importantly, that these gains resulted in concrete, tangible benefits to subscribers, especially in the form of better and more varied regulated services. Efficiency gains that permitted the buyer to improve its margins but did not benefit subscribers would not lay the foundation for allowing goodwill to be included in the rates subscribers pay.

99. Rebuttal of Presumption. In summary, we define goodwill as the portion of plant purchase price that cannot be assigned specifically to identifiable property acquired and that is not recorded on the operators books of account as accumulated losses, subscriber lists, franchise rights, patent rights or organizational costs. We conclude that goodwill, including

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[189] This includes Arthur Andersen's transitional excess acquisition cost approach. See Arthur Andersen Comments at 26-31. Arthur Andersen justifies its approach as a pragmatic alternative. Although Arthur Andersen offers numerous conditions designed to tailor these calculations to the particular circumstances of the operator, there is no rationale as to why the amount of excess acquisition adjustment that would be recovered from subscribers under this proposal represents a fair balancing of the interests of subscribers and operators. For example, Arthur Andersen proposes that an operator could demonstrate that its investment was prudent by showing that the price paid per subscriber was reasonable in relationship to prices paid by other operators during the same time period for systems with similar attributes. This test of prudent investment fails to address our concern that the ever higher prices paid per subscriber that typified transactions in the period before regulation represented the capitalization of progressively greater supracompetitive earnings expectations, and must accordingly be excluded from ratebase calculations.

going-concern value,[190] should be presumptively disallowed from the ratebase because it is likely to represent expectations of supra-competitive profits and other outlays that should not be borne by regulated service customers. We believe this approach fairly balances the interests of consumers and investors. Operators wishing to overcome this presumption should demonstrate that allowance of these costs would result in reasonable rates, that the costs were the result of an arm's-length transaction,[191] and that the goodwill has produced for subscribers concrete benefits that would not have been realized otherwise. In reviewing such showings, the franchising authority or this Commission will scrutinize the extent to which inclusion of these costs will produce rates above competitive levels. To the extent that they do, the operator will need to demonstrate why its particular situation justifies inclusion in the ratebase of these costs.[192]

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[190] We disagree with Georgia Cable that the Communications Act evidences Congress' intent that we should allow going-value concern into ratebase. Section 607 of the Communications Act was adopted in 1984, and does not necessarily evidence congressional intent that in structuring our cost-of-service regulations, we shall presumptively allow going-value concern into ratebase. Additionally, operators, to the extent that they can meet the tests enunciated in this section, can overcome any presumption of disallowance.

[191] Courts have consistently allowed regulatory authorities to exclude goodwill from determination of ratebase. See, e.g., Gavelston Electric Co. v. Gavelston, 258 U.S. 388, 396-397 (1922); Willcox v. Consolidated Gas Co., 212 U.S. 19, 52 (1909); Tele-Prompted Cable Communications Corp. v. N.J. Public Utility Commissioners, 154 N.J. Sup. 1, 380 A.2d 114 (1977) (goodwill is inappropriate in determining ratebase).

[192] To the extent that the operator seeks to justify rates above competitive levels based on inclusion of goodwill, there is a heavy presumption against inclusion of these costs. The Commission has traditionally placed the burden on telephone companies to justify inclusion of the amounts claimed as plant acquisition adjustments. See Ratebase Order and Illinois Bell. Operators making such a showing will be required to show the nature of each cost they are seeking to justify for inclusion in the ratebase, and should provide all pertinent data relating to the acquisition. At a minimum, this includes the purchase price of plant, its book value, a description of plant, the effect on subscribers, the results of a valuation study, and the results of any request for franchise approval.

100. Constitutional Issues. As we have discussed, in this Order we are substantially broadening the list of intangibles that may be included in rates by cable operators beyond those proposed in the Notice. Even intangible costs such as goodwill are only presumptively disallowed; upon a proper showing that rebuts the presumption and demonstrates that the cost does meet the tests of benefit to subscribers and rates that are not above competitive levels, the costs will be allowed. We believe that this approach assures that our treatment of acquisition costs does not impair the constitutional rights of cable operators; instead, it fairly balances the rights and interests of investors and customers. Moreover, as we explain later in this Order, we are providing for hardship showings by operators who claim that neither the benchmark/price cap nor the normal cost-of-service approach permits them the opportunity to set rates that permit them to attract capital. These procedures fully protect operators' constitutional rights.[193]

4. Plant Under Construction

i. Notice

101. In the Notice the Commission solicited comment on whether we should impose any limits on inclusion of plant under construction in the ratebase.[194] We requested comment on what practices the cable industry currently follows in accounting for plant under construction. Further, the Commission sought comment on whether it should apply the traditional rule under ratebase/ rate of return regulation, that plant under construction will be withheld from the ratebase until it meets the used and useful test, but that interest during construction can be capitalized.

ii. Comments

102. Several parties argue that plant under construction should not be allowed in the ratebase, absent a showing of severe financial distress, until it is used and useful.[195] Michigan and

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193 As the courts have made clear, "the FCC has no obligation to maintain the current market value of investors' property." Illinois Bell v. FCC, 988 F.2d at 1262; accord Hope, 320 U.S. at 601; Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1175 (D.C. Cir. 1988).

194 Notice at ¶ 42.

195 See, e.g., Michigan Comments at 15; Utah Comments at 15; Municipals Comments at 23; Seaford Comments at 11; ETC Comments at 4 (plant under construction should not be allowed in

Utah argue that any interest paid during construction could be capitalized during construction, thereby providing the operator some benefit during the construction period.[196] Georgia Cable asserts that this is not a real issue,[197] while New York requests that we allow franchising authorities to examine whether construction costs, or a portion thereof, might properly be included in the ratebase prior to completion.[198]

103. Several cable operators argue that plant under construction should be included in the ratebase, arguing that its exclusion would make financing impossible and might endanger the financial integrity of some cable operators.[199] Continental asserts that exclusion of plant under construction from the ratebase will produce a disincentive to improve technology and service.[200] Continental suggests that the appropriate method for

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ratebase because: (1) it is not used and useful; (2) inclusion may result in over-construction and imprudent investment; and (3) inclusion requires a ratepayer to pay return on investment used by future ratepayers. Instead, accrue cost of service capital incurred during construction; upon completion, if the facility is deemed used and useful, the investment, along with the accrued cost of service, can be included in ratebase).

[196] Michigan Comments at 15; Utah Comments at 15; see also NYS Commission Comments at 7.

[197] Georgia Cable Comments at 25 (cable systems rarely have plant that sits idle for very long, so whether or not to include plant under construction in ratebase is largely a non-issue).

[198] NYS Commission Comments at 7.

[199] See, e.g., CATA Comments at 15-16 (the cable industry's requirements that it grow, rebuild to accommodate technological change, and provide new services compel operators that do not sell stock to take out loans; because the operator needs to show an ability to begin repaying principal and interest from system revenues immediately, these capital costs of service must be included before the used and useful point or it will oftentimes be impossible to obtain financing); NCTA Comments at 18 (urging the Commission to study the issue of plant under construction and the interest recovery approach further before adopting a method); TMC Comments at 15.

[200] Continental Reply at 10 (not permitting any return until an entire system is rebuilt and all subscribers switch over to the new system would also result in the accumulation of losses). Continental uses the term "construction work in progress (CWIP),"

including plant under construction in the ratebase requires an adjustment to the historical test year to add into ratebase: (1) plant under construction during the years in which activation is scheduled; (2) known and measurable increases in plant under construction; (3) interest during construction; and (4) capitalized marketing costs associated with the rebuild.[201] Continental argues that to the extent that plant under construction is not allowed in the ratebase, cost of service showings will proliferate, capital management will become more problematic due to regulatory delays, and the ratebase will need to be further adjusted by interest during construction.[202]

iii. Discussion

104. In the Notice we proposed two options for valuating plant under construction for ratebase purposes, the capitalization method and the revenue requirement offset method.[203] The capitalization method is the traditional method for considering plant under construction. Under this approach, plant under construction is excluded from the ratebase, but the operator calculates an allowance for funds used during construction (AFUDC) and includes this allowance in the cost of construction. As construction is completed and the plant is placed into service, the cost of construction (including AFUDC) is included in the ratebase and recovered through depreciation.[204]

105. Under the revenue requirement offset method, plant under construction is included in the ratebase, and AFUDC is treated as part of the cost of construction. Because plant under construction is included in the ratebase, the amount of AFUDC capitalized is included in income for ratemaking purposes. This serves to offset the revenue requirement determination for the development of rates for services. Both of these methods meet

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which is apparently equivalent to "plant under construction," the term we use here.

[201] Continental Reply at 12. Alternatively, Continental proposes that the Commission could include CWIP, whether actually incurred or anticipated, in ratebase when plant becomes used and useful. At this point, the historical test year could be adjusted as described under the first approach.

[202] Id.

[203] Notice at ¶ 42.

[204] Under GAAP, AFUDC is accrued at a rate based on the actual cost of debt.

GAAP requirements.[205]

106. We are adopting the capitalization method to govern ratemaking treatment of plant under construction. This method has been used by various regulatory authorities to provide reasonable rates for utilities.[206] Further, this method will allow operators to recover interest from the construction period only after the plant is placed in service.[207] We believe that "it is in the public interest that investors receive a reasonable compensation on the funds they have provided to finance construction projects which will, when placed into service, benefit future ratepayers."[208] AFUDC will be allowed only to the extent the related costs are not already included in start-up losses.

107. Cable operators express concern that construction loans may require the operator to have more up-front capital in order to begin repaying its debt. We believe that these concerns are overstated. As portions of plant move into service, they become used and useful, and so the cost of those portions can be

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[205] We believe that by relying on GAAP, we can avoid requiring cable operators to comply with additional accounting requirements in this regard. Under the Cable Act of 1992, the Commission has a statutory mandate to minimize administrative burdens in fashioning regulations. 47 U.S.C. §543(b)(2)(A) and (B).

[206] See 47 C.F.R. § 32.2003. We acknowledge that for telephone rate regulation we are considering switching from the capitalization method to the revenue requirement offset method. See Accounting and Ratemaking Treatment for the Allowance for Funds Used During Construction (AFUDC), 8 FCC Rcd 2084 (1993). This proposed method also conforms with the requirements of GAAP. However, no decision has yet been made in that proceeding, and the more prudent course for cable regulation, at least on an interim basis, is for the Commission to use a method with which we have experience, and which we and other regulators of utilities have used and continue to use with success.

[207] Interest should be computed at prime rate or at the operator's demonstrated cost of the funds used for the construction.

[208] American Telephone and Telegraph Co., 64 F.C.C.2d 1, 60 (1977).

entered into the ratebase.[209] This approach has provided adequate recovery in the telephone area, and we believe that it will do so here.[210]

5. Cash Working Capital

i. Notice

108. In the Notice we proposed to allow operators to include in their ratebases a working capital allowance.[211] We solicited comment on several different approaches for determining the allowable amount, and stated that any of these methods could produce a negative or positive allowance, depending on operating characteristics.[212]

ii. Comments

109. Cable operators commenting on this issue generally favor inclusion of a working capital allowance,[213] but differ on

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[209] Thus, Continental's concern that the capitalization method would prevent return on any construction until all is completed, is unfounded. See Continental Reply Comments at 10. We see no need to adopt Continental's elaborate alternative of gradually including CWIP into ratebase based on a hypothetical construction schedule rather than on the actual commitment of funds to construction.

[210] We note that operators are free, under standards enunciated in this Order, to request, and demonstrate the need for, recovery beyond what is outlined in either the benchmark or cost of service approach. See part X., Hardship Showing, infra.

[211] Notice at ¶¶ 44-45. This allowance would provide a return on the funding provided by investors to support regulated operations between the time the operator pays its creditors and the time it receives payment from its customers.

[212] Id. We proposed that we might: (1) establish an industry-wide allowance; (2) require a balance sheet methodology whereby the allowance is the average difference between current assets and current liabilities; or (3) require operators to study the timing of operating revenues and disbursement flows, known as a lead-lag study.

[213] See, e.g., NCTA Comments at 17; TMC Comments at 16; Eagle Comments at 3-4.

the preferable methodology.[214] Local governments, however, favor the use of lead/lag studies, in the expectation that they would provide more accurate results.[215] Other commenters support use of the balance sheet approach (current assets - current liabilities) as an appropriate method.[216]

iii. Discussion

110. Traditionally, we have included in the ratebase of telephone companies a cash working capital allowance based on an estimate of the average amount of investor-supplied capital used to finance operations from the time that services are provided to the time that revenues are collected.[217] In that context, we have

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[214] See, e.g., NCTA Comments at 17 (operators should not be required to perform lead/lag studies because they are too burdensome); COA Comments at 69-72; Continental Comments at 56; Eagle Comments at 3-4 (all favoring a formula methodology, which would provide a fair allowance without being burdensome); TMC Comments at 16 (the Commission should establish an industry-wide capital allowance for all operators); Eagle Comments at 3-4 (a return should be allowed on working capital assets because some companies maintain an unclassified balance sheet, and they will not readily be able to make the necessary determinations).

[215] Austin Comments at 12; Michigan Comments at 16; Municipals Comments at 24; Seaford Comments at 12; Utah Comments at 16. Municipals and Seaford also state that in the absence of the lead/lag study, the working capital allowance should be zero, since cable operations provide adequate cash flows to fund operations. Accord, New Jersey Comments at 8 (operators bill a month in advance and so have funds available; thus there should be no cash working capital allowance).

[216] ETC Comments at 5; BellSouth Comments at 17-18 (the balance sheet approach is the least burdensome, and will produce approximately the same results as lead/lag studies). See also Small Operators Reply at 25-26 (small operators should have the option to use this method or a standard industry-wide allowance set by the FCC; they do not have the resources to perform lead/lag studies).

[217] See 47 C.R.F. § 65.820(d). This recognizes that where the receipt of revenues "lags" with respect to the outlay of cash for expenses, investors incur a cost for providing funds for the day-to-day operations. Receipts "lead" outlays where subscribers are billed in advance and ratebase would be reduced by the average amount of this subscriber supplied capital (i.e., a

approved several methods for determining the cash working capital allowance: lead-lag studies; a simplified formula method;[218] and a standard allowance method.[219] We have considered many factors regarding the telephone industry, and have recognized that, in that context, any one of several estimation methods will produce a reasonable cash working capital allowance.

111. The record indicates that cable subscribers are generally billed in advance for regulated cable services, and billed in arrears for nonregulated services such as pay-per-view.[220] Cable operators generally pay vendors, employees, and taxing authorities in arrears. Given these circumstances, we are adopting a presumption that a zero allowance is needed to support the regulated cable services.[221] We note that it is possible, where receipts lead outlays, to establish a negative cash working capital allowance. We believe that our zero presumption is appropriate, however, in that it takes account of the characteristics of regulated cable service provision, is fair to both operators and subscribers, and furthers the goals established by the Cable Act of 1992.

6. Other Costs - Excess Capacity, Cost Overruns, and Premature Abandonments

i. Notice

112. In the Notice the Commission sought comment on whether we should disallow from the ratebase costs that represent excess capacity, cost overruns, and premature abandonments.[222] We

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negative cash working capital allowance).

[218] The Commission-approved Simplified Formula Method is set forth in Section 65.820(e) of our rules, 47 C.F.R. § 65.820(e). It provides a methodology which is conceptually similar to the lead-lag study but does not require the same level of detail in attaining the factors for the CWC determination.

[219] See Ratebase Order, 3 FCC Rcd at 269.

[220] Telephone customers, on the other hand, are billed in arrears for long distance service, but may be billed in advance or in arrears for local service.

[221] An operator challenging this presumption must establish that its operations do not fit the industry mold, and that it requires the establishment of a cash working capital allowance.

[222] Notice at ¶ 43.

solicited comment on whether we should establish regulatory limitations or whether we can monitor industry practices and impose requirements later if necessary. We specifically sought comment on several ways that the Commission could treat excess capacity, cost overruns, and premature abandonments for ratebase purposes.[223]

ii. Comments

113. Several parties agree with the Commission's tentative conclusion that the costs of excess capacity, cost overruns, and premature abandonments should be excluded from the ratebase.[224] Michigan and Utah argue that these costs should be depreciated or amortized, which would allow operators to recover these costs over time, but not earn an annual return.[225] Austin argues that the burden should be on the operator to show that unused channel capacity or similar investments will enhance regulated services and that such investments were prudent.[226]

114. Several cable operators argue against exclusion of costs for excess capacity, cost overruns, and premature abandonments.[227] These parties argue that certain costs for expanding channel capacity remain the same for expansion of differing numbers of channels, and that it would therefore be imprudent not to expand to the largest number of channels at the same cost even where the additional channels' usage is not

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223 Id. at n.47. The options we proposed included: (1) permitting the entire cost to be included in ratebase; (2) excluding from the ratebase any costs that represent excess capacity, cost overruns and premature abandonments; and (3) as an intermediate approach, permitting depreciation or amortization of the costs of excess capacity, cost overruns and premature abandonments, but exclude them from the ratebase. We also solicited comment on the appropriate period of amortization if we permitted these costs, and on whether the return of capital should be defined to include both equity and debt capital or only debt expense. We tentatively concluded that it should include only debt expense.

224 See, e.g., ETC Comments at 4; Michigan Comments at 15; Utah Comments at 15.

225 Michigan Comments at 15-16; Utah Comments at 15-16.

226 Austin Reply at 24.

227 See, e.g., COA Comments at 67-68; Continental Comments at 54; NCTA Comments at 18.

immediately envisioned.[228] NCTA argues that the Commission should not disallow these costs if they were prudently incurred plant investments.[229] Summit suggests that GAAP and IRS guidelines should govern the treatment of excess capacity and cost overruns but fails to distinguish the cable industry from other regulated industries to justify the use of these guidelines.[230] NYS Commission states that it may be difficult to exclude the costs of excess capacity from ratebase because sometimes franchise authorities require operators to rebuild or upgrade systems to a certain size.[231]

115. BellSouth argues the middle ground that the exclusion of these costs from the ratebase should be dealt with on a case-by-case basis, with application of the used and useful and prudent investment standards to determine whether disallowance is appropriate in an individual case.[232] The Commission, BellSouth suggests, could then monitor industry practices in this regard and impose rules later, if necessary.

iii. Discussion

116. Excess capacity. We conclude that operators should be allowed to include in the ratebase any excess capacity that will be used within a twelve month period.[233] We believe it is prudent

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[228] See, e.g., Continental Comments at 54; COA Comments at 67-68 (if the Commission wants to provide incentives for the development of new technology and investment, it would be inconsistent to disallow investment in channels presently held in reserve).

[229] NCTA Comments at 18. If the Commission does exclude these costs from ratebase, NCTA argues, the Commission should provide operators a higher rate of return reflecting increased risk.

[230] Summit Comments at 8.

[231] NYS Commission Comments at 7.

[232] BellSouth Comments at 17.

[233] As noted above with regard to start-up losses, we will allow recovery of these costs only to the extent that they are recorded on the company's books as such. The amortization of allowed costs must begin at the end of the prematurity phase of operation, and should generally be completed during the service life of the longest depreciable assets. We believe this will generally be no longer than fifteen years.

for a cable operator to expand capacity beyond immediate needs, when such a present-day investment saves subscribers future costs for additional labor and equipment. We also note that telephone regulation provides for a certain limited amount of excess capacity.[234] Nonetheless, we find that cable service regulation presents a different situation than telephone regulation; here, there is no annual or biannual filing, no opportunity to adjust the ratebase downward if excess capacity does not become used and useful within a certain period.

117. Further, our price cap adjustment and network upgrade plans make adequate provision for the addition of channels and capacity. Thus we will direct that any facilities that are not currently used and useful, but will be used and useful within one year, may be included in the ratebase, but that if they are included in the ratebase, they may not in any part be reflected in annual operating expenses or in any price cap adjustment. We believe this approach strikes a reasonable balance between the interests of cable operators and those of subscribers by allowing an operator to include in the ratebase costs that benefit subscribers now or will benefit them very soon, while assuring that no double or excessive recovery of costs, and no double payment for capacity, can occur.

118. Cost overruns. We believe that cable operators should be able to recover the costs of overruns that have occurred through no fault of the operator. At the same time, we must ensure that subscribers do not bear any burden for unnecessary, extravagant, or imprudent expenses that may constitute cost overruns. We therefore find that cost overruns should be presumptively disallowed from the ratebase, but that operators may overcome this presumption on a case-by-case basis by showing that the costs were prudently invested.[235]

119. Premature abandonments. We conclude that the cost of premature abandonments should be a recoverable operating expense rather than an element in the ratebase. In removing prematurely abandoned plant from the ratebase, a cable operator must bring plant to full recovery before retiring it.[236] To retire plant,

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[234] See 47 C.F.R. § 32.2002.

[235] In making such a determination, we will examine whether the overrun was preventable, who was responsible for the overrun, and whether including the overrun in the ratebase will produce reasonable rates.

[236] Plant that has never entered into service cannot be retired and expensed, but is disallowed.

the operator must remove both plant and accumulated depreciation reserve from the balance sheet. Once the plant is retired, an operator may amortize the unrecovered investment (i.e., the original cost less accumulated depreciation) over a term equal to the remainder of the original expected life. This decision will protect subscribers by precluding recovery of a rate of return on abandoned plant, while preserving an opportunity for the cable operator to invest in more advanced technology. This approach allows the cable operator to recover the investment in outdated technology while not encouraging replacement of still useful equipment. Thus it helps achieve our goal of permitting operators to participate in the development of an advanced telecommunications infrastructure.

B. Expenses

1. Operating Expenses

i. Notice

120. In the Notice we proposed allowing cable operators to recover operating expenses as annual expenses incurred in providing cable service.[237] We tentatively concluded that plant-specific costs (e.g., maintenance), plant non-specific costs (e.g., programming expense, power, engineering and testing), customer operations (e.g., marketing, billing and collection), and corporate operations (e.g., legal, planning, accounting and finance) should be included as operating expenses that cable operators are entitled to recover in rates for regulated cable service. We tentatively prohibited recovery through regulated cable rates, of expenses unrelated to provision of regulated cable service.[238] In addition, we requested comment on whether other operating expenses should be recoverable, and on what costs should be treated as expenses in the year incurred, and what costs should be capitalized and depreciated over a number of

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[237] Notice at ¶¶ 23-24. We also tentatively concluded that while programming expense would be a recoverable operating expense, it should not be a cost element in the ratebase. Id. at n.24.

[238] Specifically, we proposed to exclude lobbying expenses, contributions for charitable, social, or community welfare purposes, membership fees and dues in social, service and recreational or athletic clubs and organizations, and penalties and fines paid on account of violations of statutes and rules. Id. at n.25.

years.[239]

ii. Comments

121. Commenters, including cable operators, programmers, state and local governments, and telephone companies, agree that the enumerated categories of expenses should be treated as operating expenses and should be recoverable in rates for regulated cable service.[240]

122. Some commenters note that our rules already exclude costs unrelated to the provision of regulated cable service.[241] Some cable operators suggest other costs that should be treated as operating expenses.[242] For example, Cablevision Systems contends that the Commission has apparently excluded costs

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[239] Id. at n.26.

[240] See, e.g., Medium Operators Comments at 15; Municipals Comments at 16; Connecticut Comments at 2. Section 79.924 applies to cable operators for which the basic service tier is regulated by local franchising authorities or the Commission or for which a complaint has been filed with the Commission regarding a cable programming service tier. The requirements of Section 79.924 are applicable in cost-of-service showings. Section 79.924(g) Unrelated Expenses and Revenues provides that

> Cable operators shall exclude from cost categories used to develop rates for the provision of regulated cable service, equipment, and leased commercial access, any direct or indirect expenses and revenues not related to the provision of such services. Common costs of providing regulated cable service, equipment, and leased commercial access and unrelated activities shall be allocated between them in accordance with subsection (f).

[241] Bell South Comments at 8, citing 47 C.F.R. § 79.924(g). See also TCI Comments at 32-33.

[242] Time Warner Comments at 22 (all reasonable expenses associated with the provision of regulated cable services, not just those enumerated in the Notice, are to be included and recovered). Time Warner argues that expenses related to regulated service, such as pole attachment fees, employee training, customer service, vehicle expenses, copyright fees, local origination, and all salaries and related benefits should clearly be included. See also TCI Comments at 32; Small Cities Comments at 21-22.

associated with system power, security, and quality assurances from operating expenses recoverable through rates for regulated services.[243] Medium Operators states that advertising costs associated with regulated programming services should be included as a recoverable operating expense.[244]

123. The exclusion of special expenses from recovery generated debate among commenters. Eagle agrees that special expenses should not be recoverable.[245] While not opposed to the exclusion generally, Small Systems states that such expenses are relatively small, and that most operators do not list them separately on their books.[246] BC states that any charitable contribution made in fulfillment of a franchise agreement or made to a local school or other governmental facility in the franchise area should be recoverable in basic service rates.[247] Continental similarly argues that charitable expenses, club fees, and other money expended in the franchise community should be allowed as necessary operating expenses.[248] Cablevision Systems agrees with the concept of excluding recovery of unrelated expenses, but believes that unrelated expenses and costs should be identified on a case-by-case basis.[249] State and local governments generally

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[243] Cablevision Systems Comments at 40. Georgia Cable assumes that management fees are allowable expenses. Georgia Cable Comments at 12.

[244] Medium Operators Comments at 15-16. Medium Operators believes that operating expenses, excluding depreciation, amortization and income taxes, should be presumed reasonable as long as they are supported by audited financial statements.

[245] Eagle Comments at 2.

[246] Small Systems Comments at 3, n.3 (asserting that it would be administratively burdensome to separate out these expenses).

[247] BC Comments at 13.

[248] Continental Comments at 81-82; Georgia Cable Comments at 13; COA Reply at 34. <u>But see</u> NATOA Reply at 10-11 (lobbying costs, membership dues and charitable contributions are discretionary expenses made solely to advance the operator's business interests and boost its profits).

[249] Cablevision Systems Comments at 40.

support the exclusion of special expenses.[250] BellSouth believes that the Commission should permit a reasonable allocation of such costs to be recovered through rates for both cable operators and telephone companies.[251] Bell Atlantic supports exclusion of special expenses.[252]

124. Little comment was directed to which costs should be expensed and which should be capitalized. Small Systems suggests that all budgeted capital expenditures to be made within the following 12 month be included in the ratebase.[253] ETC argues that we should establish clear criteria for expenses that should be capitalized pursuant to IRS and GAAP guidelines.[254]

iii. Discussion

125. We will permit recovery of all operating expenses normally incurred by cable operators in the provision of regulated cable service. This will permit cable operators to recover fully the reasonable costs of providing regulated service, while protecting ratepayers from paying rates that reflect costs not reasonably associated with regulated services.

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[250] See, e.g., Municipals Comments at 16; Seaford Comments at 9 (specifically arguing for exclusion of expenses associated with lobbying of elected officials); New Jersey Comments at 5.

[251] BellSouth Comments at 10. BellSouth believes, however, that if the Commission continues to exclude such costs from telephone service rates they should be excluded from rates for regulated cable services.

[252] Bell Atlantic Comments at 20-22. Bell Atlantic, advocating the same treatment for cable operators and telephone companies, argues for exclusion of all cable expenses related to lobbying and other items referred to in Section 32.7370 of the Commission's rules (47 C.F.R. § 32.7370). Bell Atlantic Comments at 22, n.45. Section 32.7370 is part of the Uniform System of Accounts for telephone companies and presumptively excludes special charges: lobbying; contributions for charitable, social or community welfare purposes; membership fees and dues in social, service or recreational or athletic clubs and organizations; penalties and fines paid on account of violations of statutes including fines paid for violations of U.S. statutes; and abandoned construction projects.

[253] Small Systems Comments at 17.

[254] ETC Comments at 6. Accord, BellSouth Comments at 10; Georgia Cable Comments at 12.

We affirm our decision to exclude from recovery those operating expenses and other costs unrelated to the provision of regulated cable service pursuant to our proposed cost accounting and cost allocation rules.[255] We note that the examples of operating expenses provided in the Notice were not meant as an exclusive list of the only types of operating expenses available for recovery. Other costs incurred in the provision of regulated cable service are recoverable if legitimate and reasonable.[256] The Commission and local franchising authorities will, however, review operating expenses in each cost showing to assure that they meet our cost standards. In this way we can ensure that a cable operator that elects to make a cost-of-service showing is able to recover all fair and reasonable costs incurred in serving its customers.

126. We also adopt our tentative conclusion that certain special expenses are presumptively excluded from recovery as not reasonably related to the provision of regulated cable services.[257] Cable ratepayers should not be responsible for reimbursing cable operators for unreasonable costs. We further conclude that, for the time being at least, GAAP should guide the determination of costs to be expensed and those that must be capitalized by each cable operator.[258]

2. Depreciation

i. Notice

127. In the Notice we tentatively concluded that the Commission should prescribe depreciation rates for purposes of developing cost-based rates for regulated cable service. We noted several different prescription methods and asked for comment on which was most suitable.[259] We also asked commenters

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[255] See 47 C.F.R. § 76.924(f) and (g).

[256] See, e.g., our adoption of a programming mark-up, in our companion Benchmark Order at III.B.3.

[257] See 47 C.F.R. § 76.924(f) and (g).

[258] We note that the proposed uniform accounting system contained in Attachment C provides detailed instructions on how cable operators are to determine costs that are to be expensed and costs that are to be capitalized.

[259] Notice at ¶ 27. We noted that the prescription could be an industry-wide depreciation rate, a band of reasonable rates, or individual rates for each plant category. Cable operators

to address the necessary number of depreciable plant categories, evidence that should be taken into account in setting rates, and whether we should prescribe recovery on a straight line remaining life basis or use some other methodology. We tentatively concluded that depreciation rates should be based on book value of the asset as opposed to its economic or fair market value.

128. In addition, we tentatively concluded that any depreciation rates we prescribe should be designed accurately to reflect, and recover, the costs of the asset over its useful life.[260] We requested comment on what the impact on cable rates would be if we prescribed, for the purpose of a cost-of-service showing, depreciation schedules designed to allow recovery of capitalized costs over the maximum reasonable expected life of the plant. We sought comment on a number of current industry depreciation practices, and on the useful life and salvage value of all categories of facilities used by cable operators to provide regulated cable service. Finally, as an alternative to prescription of depreciation rates, we asked whether we should for the time being only monitor operator depreciation practices.

ii. Comments

129. Most cable operators oppose our tentative conclusion, or argue for deferral of consideration of this issue. Cablevision Industries states that treatment of depreciation for ratemaking purposes poses a challenge due to the many changes affecting the cable industry.[261] Other cable operators argue that the Commission should defer consideration of depreciation rules to a later time or a second phase of this proceeding.[262]

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could be required to use company-wide expense as reported in Securities and Exchange Commission ("SEC") financial statements. Alternatively, we could link depreciation to specific circumstances in each franchise or adopt some other standard.

[260] Id. at ¶¶ 28-29.

[261] Cablevision Industries Comments at 44 (recommending that we establish uniform standards governing depreciation while allowing operators a degree of flexibility in applying them in individual circumstances). See also Small Systems Comments at 11. Small Systems has no objection to industry-wide depreciation schedules as long as they are fairly derived.

[262] See Comcast Comments at 4 and 45; California Cable Comments at 45; CATA Comments at 17 (". . . prescription of depreciation rates at this time would be a mistake."). NCTA believes that, at this stage, the Commission should monitor

Cablevision Systems urges the Commission to adopt a monitoring approach instead of prescription;[263] COA believes it would be better for the Commission to accept current depreciation practices, monitor results, and correct for observed abuses.[264]

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depreciation practices. Should the Commission decide to prescribe depreciation rates, however, it must do so on a case-by-case basis. NCTA Comments at 25-27.

[263] Cablevision Systems Comments at 35-36 (stating that it would be willing to justify its depreciation practices in a cost-of-service showing or report on its practices pursuant to Commission information collection rules). See also Eagle Comments at 2-3 (adds administrative costs, especially for small cable operators); Media General Comments at 12 (GAAP is adequate); Georgia Cable Comments at 13-15; Medium Operators Comments at 22-24. Medium Operators submits the executive summary of a 1986 study by Ernst & Whinney (E&W) comparing the procedures used to account for depreciation by the telephone industry and by companies in industries with related characteristics. Medium Operators Comments at Exhibit 6, Ernst & Whinney Review of Depreciation Policies and Procedures in Selected Industries, Prepared for The United States Telephone Association December 6, 1986 (E&W 1986). E&W concludes that non-regulated companies generally expend very little effort evaluating depreciation methods, lives, and salvage. E&W 1986 at vi. Cable companies, E&W found, use franchise duration as the depreciable life of assets, apply depreciation rates to categories of equipment, use straight line depreciation methods, and ignore salvage as immaterial in developing depreciation rates.

Medium Operators also submits a study by Ernst & Young (E&Y) of the impact of the FCC's proposed cost-of-service rules. Medium Operators Reply at Attachment: Ernst & Young Cost-of-Service Regulation for Cable Operators (E&Y 1993). E&Y compares the range of depreciation rates of telephone and cable companies in 1986 (in E&W 1986) and 1991-2. In 1986 depreciation rates ranged from 6% to 9% for telephone and 4.25% to 10% for cable. In 1991-2 depreciation rates ranged from 6.7% to 7.5% for telephone and 6.4% to 16.2% for cable. Of the nine cable systems surveyed in 1991-2, seven had depreciation rates above the highest surveyed telephone rate. Three were above 13% and two were using accelerated depreciation methods. E&Y 1993 at 31-32. E&Y argues that the observed increase in variance in cable depreciation rates is due to anticipations of system rebuilds and should be allowed.

[264] COA Comments at 79 and Exhibit F at 49.

COA offers as a possible method to determine depreciation rates the "price cap carrier option" considered recently in a separate proceeding.[265] Under this option, common carriers subject to price caps would file proposed depreciation rates with the Commission. The Commission would propose to adopt the carriers' proposed rates and seek comment on their reasonableness. Prescription of rates would be based on the proposed rates and any comments made thereon.

130. The majority of local and state governments filing comments support prescription of depreciation rates,[266] but nonetheless are concerned about implementing prescription at the franchise level, which they believe would be too administratively burdensome.[267] New York advocates use of a band of industry-wide reasonable rates with a band of individual rates for each plant category.[268] Connecticut believes that monitoring of depreciation practices will suffice if cable operators are required to explain and justify their practices in the cost-of-service filings.[269]

131. Telephone companies offer different prescription approaches. Bell Atlantic favors uniform practices for cable and telecommunications companies.[270] GTE suggests formulating a depreciation standard for price caps that would be applied in

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[265] COA Comments at 78. Accord Continental Comments at 87. See Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, 8 FCC Rcd 8025 (1993) (Simplification Order) at ¶ 38.

[266] See, e.g., Municipals Comments at 17 and Seaford at 9-10 (apply all of the methods and procedures used to prescribe depreciation rates for local exchange carriers); Michigan Committee Comments at 10-11 and Utah Comments at 10-11 (establish an industry-wide depreciation rate); New Jersey Comments at 6 and A4; New York Comments at 7.

[267] See, e.g., Utah Comments at 10-11; Michigan Committee Comments at 10-11.

[268] New York Comments at 7.

[269] Connecticut Comments at 2. Connecticut also notes that depreciation is an extremely complex area, franchising authorities have not routinely evaluated depreciation in the cable industry for many years, and the potential effects on subscriber rates are great.

[270] Bell Atlantic Comments at 22.